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CALSTRS
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April 11, 2005

The Honorable Joseph Dunn, Chair
Senate Budget Committee, Subcommittee #4

The Honorable Rudy Bermudez, Chair
Assembly Budget Committee, Subcommittee #4

The Honorable Jack Scott, Chair
Senate Budget Committee, Subcommittee #1

The Honorable Mervyn M. Dymally, Chair
Assembly Budget Committee, Subcommittee #2

Dear Committee Chairs:

I wanted to take this opportunity to express to you the position of the Teachers' Retirement Board with respect the Governor's budget proposal to eliminate permanently the State of California's General Fund contribution to the CalSTRS Defined Benefit (DB) Program, and to shift this cost to California's schools and community colleges. At its February 2005 meeting, the CalSTRS' Board voted 11-0-1 to oppose this proposal based largely upon the following three concerns:

- The proposal is actuarially unsound because it eliminates the State's current obligation to make an additional contribution to the DB Program when there is an unfunded liability as to the benefit structure in place prior to 1990;
- By providing that school and community college employers can shift the increased cost to our members through collective bargaining, and by allowing our members to "opt out" of their 2 percent contribution to the Defined Benefit Supplement (DBS) Program, the proposal violates the vested rights held by our members;
- The proposal has the potential through the opt-out provision to create an unwieldy administrative system that will create serious data integrity problems that ultimately impact our members' benefits and increase operational costs. Without exaggeration, this element of the proposal creates an administrative nightmare for the System, our employers and members.

Since these proposals were developed in isolation without the benefit of System input as to the administrative cost and efficiency implications nor without independent actuarial or legal review, we provided the Department of Finance with the following more detailed explanation in the hope that Finance might address these key legal, actuarial and administrative weaknesses when it considers revisions to its budget proposal later this spring. I also met with Tom Campbell, the Director of Finance, on February 23, 2005 to further explain our concerns.

Background

Consistent with the historical importance it has placed upon education, the State of California has made contributions to CalSTRS since 1913. In 1990, CalSTRS worked cooperatively with State government to fashion a contribution structure that addressed both the State's short-term fiscal needs and CalSTRS' long-term funding needs. The end result was that the State, in exchange for a waiver of its obligation to make a contribution to CalSTRS' DB Program for one fiscal year, made a permanent commitment to increase future annual contributions to 4.3 percent of creditable school and community college payroll. Under that agreement (known as "Elder Full Funding"), if and when the CalSTRS DB Program was fully funded, the General Fund contribution would decline by .25 percent per year until there was no remaining General Fund contribution. Further, if after a period of these incremental decreases the DB Program again experienced an unfunded liability, the General Fund contribution would increase incrementally, by the same .25 percent factor, to a maximum of no more than the original 4.3 percent.

CalSTRS' actuarial valuation as of June 30, 1998, showed that the DB Program was fully funded and had a surplus. As noted above, the State's contribution under existing law under these circumstances would have declined by only .25 percent; from 4.3 percent to 4.05 percent. In recognition of the State's need for more immediate rate relief given the circumstances of the State Budget and the recruitment and retention needs of the school system, a deal was fashioned between the State and CalSTRS to reduce immediately the State's contribution to the DB Program to 3.102 percent in exchange for modest benefits increases. A provision of this agreement provided that in the event that CalSTRS experienced an unfunded liability in the benefits structure in place on July 1, 1990, the State would make an ***additional*** 0.524 percent contribution. The State's contribution rate was further reduced in 2000 from 3.102 percent to its current 2.107 percent, retaining the same contingent contribution increase feature described in the preceding sentence. These reductions have saved the General Fund a total of almost $2.7 billion in contributions through 2004-05 that otherwise would have been paid to CalSTRS.

The current proposal

We are now faced with a unilateral proposal to eliminate permanently any General Fund contribution to CalSTRS. As we understand the proposal, the State proposes instead to shift its responsibility to California's schools and community colleges. While this certainly departs from the spirit of past agreements described above, in and of itself this proposal would not abrogate the vested rights of our members so long as the schools and community colleges make up the contributions. Nor would it by itself cause undue administrative implications. However, as noted above, the proposal in its current form is deficient in three respects:

The proposal is actuarially unsound

Our actuary has reviewed the proposal and has advised our Board that while the proposed shift of the State's base contribution to the schools does not harm the funding of the System, it is nevertheless actuarially unsound because it eliminates the State's obligation to make the additional 0.524 contribution rate in those times when there is an unfunded liability in the benefits structure in place as of July 1, 1990, without providing a substitute source of funds.

The proposal impairs the vested rights of CalSTRS members

As we understand it, the proposal provides for the possibility of school and community college employers to shift the increased contribution responsibility to their employees through the collective bargaining process, and additionally allows members to "opt out" of their 2 percent contribution to the DBS Program through the July 1, 2010 sunset date of this contribution. Our outside fiduciary counsel has opined that to the extent that members are required to increase their contributions to the DB Program, this could be viewed as an impairment of a vested contractual right for which no comparable offsetting advantage has been provided. Moreover, the possibility of the member "opting out" of the DBS contribution to offset the increased DB contribution does not alter this conclusion because under that scenario the member would suffer a decrease in their DBS benefit with no offsetting advantage. Although the budget language that Legislative Counsel has drafted does not currently recognize that the 2 percent contribution would need to be restored to the Defined Benefit Program following the sunset of the DBS 2 percent diversion, we understand from representations of the Department of Finance that it was the administration's intention to do so. Needless to say, if the 2 percent were not restored in 2010, the legal impairment is dramatically compounded by this action.

The proposal creates a costly administrative nightmare

Further, the likely result of this proposal, if enacted, would be an infinite range of collectively-bargained member and employer contribution rates throughout the State, creating an impossible administrative burden and significant cost both for CalSTRS and our employers. From a pure common sense business perspective, this approach substantially increases the risk of data problems that will increase our costs to manage and equally importantly create a confusing benefit structure to the membership.

For these reasons, we strongly recommend that the Legislature **not** adopt the statutory changes required to implement the budget proposal. If you have any questions on this matter, please contact Ed Derman, Deputy Chief Executive Officer, at (916) 229-3714.

Sincerely,

Jack Ehnes
Chief Executive Officer

cc: CalSTRS Board
Tom Campbell, Dept. of Finance